1031 Exchange FOCUS

SECTION 1031 OF THE INTERNAL REVENUE CODE IS ONE OF THE GREATEST WEALTH BUILDING TOOLS AVAILABLE TO THE INVESTOR

TAX BREAKS! USING 1031 AND 121 TOGETHER...

Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property and exchanging into other like- kind investment property.

Tax Breaks for the Savvy Investor

They say that in life only two things are certain: death and taxes. Savvy investors however have recently been given the means to avoid the latter in certain real estate transactions.

Until recently real estate was classified as either an *investment* or a *primary residence*. Upon the sale of property, different tax breaks were available depending on how the property was classified.

If the property was considered an investment, Section 1031 of the Internal Revenue Code could be used to *defer* the payment of capital gains taxes.

If the property was considered a primary residence, Section 121 of the Internal Revenue Code could be used to *avoid* the payment of capital gains taxes. Section 121, also known as the homeowner's exemption, allows taxpayers who have owned and lived in a primary residence for 2 of the past 5 years to avoid taxes on capital gains. If the taxpayer is single, the first $250,000 of gain is exempt, if married, the first $500,000 of gain is exempt.

Recently, the IRS has stated that some real estate transactions can benefit from both Section 1031 and Section 121.

Here's how it works:

A married couple lives in a home for 5 years and has a gain of $600,000. If the married couple were to sell the home as their primary residence, the couple could qualify for Section 121 of the Internal Revenue Code and avoid paying taxes on the first $500,000 of gain. In this case however, that leaves our married couple with a tax bill on the excess $100,000 gain (approximate $25,000 in taxes).

However, with the new IRS ruling, instead of selling the home as a primary residence, our savvy married couple decides to move out and convert their highly appreciated home into a rental. The couple rents the house out for 2 years, and then sells that house as an "investment".

Now that the house is classified as an investment, our couple is eligible for tax deferral via Section 1031 of the Internal Revenue Code but because the property was also a principal residence for 2 of the past 5 years, they are also eligible for their Section 121 homeowner's exemption.

By converting the house to an investment, the married couple can avoid paying taxes on the first $500,000 of gain, and defer the payment of any gain in excess of $500,000. Keep in mind, most tax advisors believe 1-2 years to be a sufficient time to rent out the property for it to qualify as an "investment"—but be careful not to rent the home out too long—as it must have also been used as a primary residence for 2 of the past 5 years!

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